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Thursday, April 4, 2002

STRAIGHTLINE INVESTMENTS, INC.

No. 97-13375

[Debtor](#)  (s).

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CHARLES E. SIMS, [Trustee](#) ,

[Plaintiff](#)  (s),

v.

A.P. No. 99-1249





CHARLES D. AALFS,

[Defendant](#)  (s).

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## **Memorandum of Decision**

### **I. Introduction**

Debtor Straightline Investments, Inc., filed its [Chapter 11](#)  petition on September 10, 1997. On October 20, 1997, it filed a motion seeking to borrow up to \$500,000.00 from defendant Charles Aalfs pursuant to § 364(c) of the [Bankruptcy Code](#) . The loan was to be a junior [lien](#)  on the debtor's equipment and a senior lien on all new inventory and its proceeds. The motion was opposed by the [United States Trustee](#)  and Six Rivers National Bank.

After a hearing, the court ordered that the debtor could borrow only \$100,000.00, and the

loan was to be secured only by the junior lien on equipment and the senior lien on the inventory. The court did not authorize any further borrowing.

Although it was not known at the time, the request to borrow was not made with the intent of keeping the debtor operating. Rather, it was made with the intent to eventually transfer the debtor's saw mill business to Aalfs. By limiting the borrowing to \$100,000.00, the court was thwarting these plans.

Although Aalfs was fully aware of the bankruptcy and the court's order limiting the debtor's borrowing from him to \$100,000.00, he and the debtor's principal, Matthew Galt, decided that they could circumvent the court's order by "selling" the debtor's accounts to Aalfs and calling the transactions sales in the ordinary course of business. Over the next several months, the debtor "sold" accounts having a face value of \$200,600.00 to Aalfs for \$186,456.00, all without any sort of notice or court authorization. Galt gave Aalfs his personal guarantee to make good any losses. Aalfs and the debtor had done no similar transactions before bankruptcy, either between themselves or with other parties. Aalfs collected \$163,007.00 of the receivables.

A Chapter 11 trustee was appointed in April, 1998, and the case converted to [Chapter 7](#) shortly thereafter. In this [adversary proceeding](#), the trustee seeks to recover the value of the receivables from Aalfs pursuant to § 549(a) of the Bankruptcy Code, which permits the trustee to avoid transfers of estate property made after the commencement of the case and without authorization of the court or the Code.

Aalfs argues that the transactions were in the ordinary course of business, and therefore authorized by either § 363 or § 364 of the Bankruptcy Code. He is incorrect in this analysis.

## **II. Borrowing Under § 364**

Section 364(a) of the Bankruptcy Code authorizes a debtor in possession to incur debt in the ordinary course of business "unless the court orders otherwise." The debtor had asked the court for permission to borrow \$500,000.00 secured by equipment, inventory and receivables. The court listened to the motion and objections, and then authorized the borrowing of only \$100,000.00 secured only by equipment and inventory. Once the court ruled, the ordinary course provision of § 364 was no longer applicable as the court had "ordered otherwise." Any borrowing outside the order was unauthorized.

## **III. Sales Under § 363**

Aalfs' next position is that the transactions were purchases, not loans, and were authorized by § 363(b) of the Bankruptcy Code as outright sales. That section does not specifically authorize sales, but provides that a debtor in possession may sell estate property out of the ordinary course of business after notice and a hearing. The negative implication is that property sold in the ordinary course of business need not be noticed. There are numerous problems with Aalfs' theory.

First and foremost, form is not exalted over substance in bankruptcy proceedings. *Pepper v. Litton*, 308 U.S. 295, 305 (1939). Where the purchaser does not bear the ultimate risk of loss, a “sale” may be more properly identified as a loan. *In re The Woodson Company*, 813 F.2d 266, 271 (9th Cir. 1987). Having failed in its attempt to obtain leave to borrow against the receivables, the debtor was not free to circumvent the ruling of the court by calling the alienation of its receivables “sales.”

Second, the debtor’s records called the transactions “advances” and Aalfs’ employee referred to them as “loans.” Aalfs and Galt clearly thought that by cleverness they were accomplishing exactly what the court had forbidden.

Third, § 363(e) of the Bankruptcy Code gives the court the power to prohibit or condition the sale of any assets. The effect of the court’s prior order was exactly that.

Fourth, the “sales” were not in the ordinary course of the debtor’s business. A sale cannot be in the ordinary course of business if a [creditor](#) would expect notice and a hearing on a contemplated transaction. *In re Dant & Russell, Inc.*, 853 F.2d 700, 705 (9th Cir. 1988); *In re Media Center, Inc.*, 115 B.R. 119, 123 (Bkrcty.E.D.Tenn. 1990). In this case, the court had been asked to rule on the hypothecation of receivables and had denied the debtor leave to do so. Creditors would have reasonably expected that from that time forward they would be given notice of any attempt to transfer the receivables.<sup>(1)</sup>

#### **IV. Recoupment**

Aalfs argues that the equitable doctrine of recoupment somehow justified the transactions. The court does not see how the doctrine is applicable at all, but notes that an equitable remedy may never be invoked to an inequitable purpose. In this case, the debtor and Aalfs were engaged in a conspiracy to circumvent the order of the court and to transfer the debtor’s assets to Aalfs. An equitable doctrine cannot be invoked for such purposes.

#### **V. Diminution of Estate**

Aalfs argues that since he paid hard money for the estate’s receivables the estate was not diminished. This may be true, but it misses the point. Section 549(a) provides for no such defense, nor does the sole case cited by Aalfs for this proposition remotely support it. The only defense afforded to the recipient of an unauthorized [postpetition transfer](#) is provided in § 550(b)(1) of the Code, which provides that the trustee may not recover from a transferee who took for value. However, in order to invoke § 550(b)(1), the transferee must have taken in good faith and without knowledge of the voidability of the transfer. Aalfs certainly does not qualify. He knew about the transfer, knew about the court’s order, and was involved in a scheme to divest the estate of its assets.


#### **VI. Conclusion**

The transfers to Aalfs of the debtor’s accounts are avoidable under § 549(a) of the Bankruptcy Code. Since Aalfs did not take in good faith, he is liable for the value of the

receivables he collected and the return of any uncollected receivables. Judgment shall accordingly be entered against him in the amount of \$ 163,007.00, <sup>(2)</sup>plus interest at the legal rate from and after the date of the filing of the complaint, plus costs of suit. The transfer of all uncollected receivables is also avoided and they shall be returned to the estate.

This memorandum constitutes the court's findings and conclusions pursuant to FRCP 52(a) and FRBP 7052. Counsel for the trustee shall submit an appropriate form of judgment forthwith.

Dated: April 4, 2002

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Alan Jaroslovsky  
U. S. [Bankruptcy Judge](#) 

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